From mutual insurance to fiscal federalism: Rebuilding the Economic and Monetary Union after the demise of the Maastricht architecture

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ABSTRACT

The policy response to the current European crisis has largely focused on its financial symptoms rather than on its deep economic and political causes. The aim of this paper is to contribute to the debate about the current architecture of the European Economic and Monetary Union. The crisis has cracked the intellectual consensus and the political compromise that underpins the architecture of the monetary union enshrined in the Maastricht Treaty. The intergovernmental insurance mechanism that has emerged in response to the crisis could offer a path to buttress the existing architecture, but it is economically limited and politically unsustainable. Indeed, the mutualisation of economic risks that has started tacitly through various mechanisms (European Stability Mechanism, interventions by the European Central Bank) cannot succeed without a more profound rebuilding of the monetary union that involves a move towards pooling of resources and a form of fiscal federalism.

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1. Introduction: the original sin

The financial crisis that erupted in 2007 became a distinctly European crisis in October 2009 when the newly elected Greek government turned the music off and cast light on the abysmal state of its public finances. Since then, the European policy response has largely focused on dealing with the financial symptoms rather than the economic and political root causes of the euro-area crisis. It has focused on fiscal consolidation efforts across the currency union, largely on the basis of an incorrect diagnosis of the supposedly fiscal nature of the crisis. Only in the spring of 2012 did European policymakers start to recognise and accept publicly that the architecture of the monetary union itself was at least partially at the origin of the crisis and its continued worsening. This has sparked a vivid intellectual debate about the shortfalls in the current architecture and has highlighted a number of flaws in the original design of the monetary union.

The first and the most salient one is the benign neglect of the financial system. The fact that a stable and increasingly integrated financial system would drive the economic integration and the performance of the euro area was well understood. But the reverse—that is, the fact that financial instability and fragmentation could in turn become an existential threat to the currency union—was never seriously envisaged. As a result, the monetary union promoted an extraordinary degree of financial integration while allowing financial institutions to remain regulated, supervised and eventually resolved along purely national lines. This undoubtedly exacerbated inadequate incentives and vicious dynamics of political capture that undermined the quality and rigour of supervision, weakened credit standards and fostered a form of financial repression that encouraged banks to dangerously build up portfolios of national government debt and eventually made the resolution and restructuring of troubled banks both longer and more costly to European taxpayers.

As much as this omission is striking today, it was certainly more the result of a cognitive lapse or an intellectual blind spot. What could have been benign blunder was compounded by a generalised and global dysfunction of financial markets fuelled by excessive leverage, inadequate self-regulation and pernicious incentives. The prolonged meeting of a globally disenfranchised financial system and an inadequate architecture eventually produced the Euro crisis we know.

But there were more troubling omissions in other areas where there was ample scholarship and where there had been far more political discussion. Walters (1990) had for instance explained early on the dangers of a single monetary policy applied to a profoundly heterogeneous zone. He argued forcefully that divergent levels of real interest rates would lead to pro-cyclical credit developments and destabilising asset bubbles. Even as divergent levels of inflation were observed in the early years of EMU, the conventional wisdom concluded optimistically that these were transitory developments linked to convergence that did...
not require a specific policy response or amendments to the underlying architecture. In addition, the widespread belief in rational expectations assumed that these developments would soon be gradually internalised by economic agents. The prevailing monetarist consensus suggested that asset bubbles should not be the concern of central bankers (or really anyone for that matter).

Finally, a more fundamental and less excusable omission eventually took hold in the final construct. The consequences of monetary unification on fiscal policy had been studied in depth in earlier moments of the monetary integration process but were deliberately ignored in the years leading up to the Maastricht Treaty. Kenen (1969), quite early on, argued that currency areas not meeting all the features of an optimal currency area could still thrive so long as a fiscal authority arranged the necessary transfers to absorb shocks and disparities between regions of the monetary union. This concurred with work on the matter ordered by European authorities themselves. The Werner (1970) Report had for instance already highlighted that the monetary union would require public budgets to be decided at the Community level. This was actually the main reason why Georges Pompidou opposed it in 1971 arguing that: “only the Nation State could face the brutality of capitalism”. As a result, the currency unification project was left astray but more reports followed, the Marjolin (1975) Report argued that a monetary union required a central budget and automatic rebalancing mechanisms that should include the centralisation of unemployment insurance. The McDougall (1977) Report suggested that a monetary union required at least a budget of 2–2.5% of GDP in a pre-Federal stage, then 5–7% in a federal stage in order to absorb economic shocks and provide a minimum degree of income convergence. But even though technical reports piled up to make this case, the single currency appeared ever more distant. It was only in June 1988 that Jacques Delors, freshly re-elected at the helm of the Commission, was tasked to form a Committee to revive the monetary integration and unification process. Departing from the tradition of ambitious and technical reports on the matter, Delors took its political acceptability at heart and steered the Committee for the Study of Economic and Monetary Union to produce the key features of a politically acceptable staged roadmap towards a minimalist monetary union. This paper analyses the main features of the intellectual and political consensus produced by the Delors Committee (section 2), it then proceeds to describe how the euro crisis has chattered this consensus and uncovered the weakness in the architecture of the euro area (section 3), it then proposes a path for repairing the essential flaws of this architecture (section 4), in particular by replacing the logic of mutual assistance that has emerged during the crisis with the creation of the European Stability Mechanism and other instruments by a process leading to a form of fiscal federalism in the euro area (section 5). Section 6 concludes the paper.

2. The Delors committee and its discontent

The Delors consensus essentially rested on the idea that the European Monetary Union was perfectly achievable without a commensurate degree of budgetary integration. Many disagreed and the Bundesbank itself had in fact written an extensive report warning that: “[the project] would be doomed to failure unless a minimum degree of economic and fiscal consensus and decision-making occurs on the level of the Community”. Yet the prevailing political imperative crystallised and found its way to the Maastricht Treaty. This compromise largely reflected the political common denominator of the time and was essentially betting on the idea that convergence could be achieve by the Maastricht criteria alone and that economic integration would deepen and accelerate such that it would reduce the need for a common budgetary authority able to stabilise the economy. The former proved incorrect and the convergence momentum quickly dwindled but was hidden by better economic performance and the latter appeared desperately hopeful but also contradicted prominent academic work that highlighted the importance of internal transfers within a monetary union. Sala-i-Martin and Sachs (1991) had demonstrated the importance of federal transfers in the case of the US

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for instance and even if their results were later played down by Von Hagen and Hammond (1998),
they both concluded that there was indeed a real need to insure against temporary asymmetric shocks
but that permanent redistributive transfers should remain a national prerogative. However, while the
differences between country-specific shocks—asymmetric shocks—that can be either permanent or
cyclical and shocks affecting all economies—symmetric shocks are intellectually clear, it is difficult to
make in practice (Table 1). Questions related to the need for income convergence were also largely
outsourced to the EU or to the single market and never were an integral part of the currency union’s
economic policy discussion while it is clear that EMU also has redistributive consequences.

This debate was also influenced by the extent to which EMU could be considered a real Optimal Current
Area (OCA). The OCA debate raged through the 1990s because the optimality of the currency area had
implications not only theoretically to assess the suitability of EMU but more practically for the design of its
architecture. This debate was profoundly influenced by two seminal papers: Paul Krugman’s Lessons from
Massachusetts for EMU (1993) highlighted the presence of increasing return to scale that could precipitate
regional concentration and clustering. This would surely increase regional specialisation and eventually
make the monetary union more heterogeneous over time. On the contrary, Frankel and Rose (1996) strongly
argued that the monetary union would boost intra-industry trade in response to decreasing transaction
costs, which would deepen financial and trade integration and therefore reduce regional cyclical asymmetry
and increase income convergence. The idea of endogenous convergence through trade rather than
asymmetry fuelled by regional specialisation became the predominant interpretation and comforted the
faith that minimal policy intervention would be necessary.

As a result of all the associated policy uncertainty and as consequence of the intellectual confusion
between idiosyncratic shocks affecting economies and idiosyncratic policies10 potentially fuelling these
shocks the need for a central authority to respond to these shocks was largely ignored or minimised. In this
context, the coordination of national economic policies11 rather than genuine common instruments; guiding
rules rather than pooling of economic policy decisions were seen as both economically and politically
preferable to a real and complete federalisation of economic policy in all its aspects.

This academic and political common denominator coincided with an intellectual moment where
Keynesianism was on the wane and where a new strand of public economics scholarship raised
doubts about the role of governments in general and fiscal policy in particular. Against this
background, the single currency as designed by Delors12 and cemented by the Maastricht treaty set
sail in 1999 on a flat sea but a cloudy horizon. The relative stability and performance of the euro area
in its first 10 years of existence gave some credit to this approach even if questions about divergences
emerged13 in intellectual circles. Yet it never really permeated to policies and allowed to affirm the
“coming of age14” of the euro thereby reinforcing the conviction that EMU could challenge economic

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<td>Permanent redistributive transfers/adjustment</td>
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10 European Fiscal Union: A Vision for the Long Run, by Cottarelli, Fiscal Affairs Department, International Monetary Fund
11 The principles of macroeconomic policy coordination were laid out by Alexandre Lamfalussy in an annex to the final
Delors Report but he expected the extent to which coordination of economic policies in other monetary unions relied on much
more integrated framework than what was being arranged in Europe.
12 See Verdun (1997).
13 Discussions around divergence emerged relatively early at the ECB, were raised repeatedly by its president in the
eurogroup and became an area of public and academic discussions starting 2007.
gravity, despite the staunch disbelief across the Atlantic.\textsuperscript{15} But the crisis that erupted in 2009 has cracked shattered the \textit{Delors consensus} and revived a deeper soul-searching about the consequences and effects of monetary unification in Europe and initiated a movement of de facto mutualisation of economic risks that had been deliberately sidelined and that now needs to be formalised.

3. The end of the \textit{Delors consensus} and the new political economy of the monetary union

At the onset of the crisis, there was no fiscal instrument in place to deal with large economic shocks affecting the zone as a whole. National automatic stabilisers alone, tailored for “great moderation” shocks, proved insufficient and national discretionary fiscal policy, although effectively coordinated by the European Commission\textsuperscript{16} in December 2008, had uneven effects suggesting that the aggregate and the distribution of the stimulus for each country was probably inadequate. Monetary policy, which would be able to respond to symmetric shocks of large magnitude, was quickly hampered by financial distortions that undermined the monetary policy transmission mechanisms. Conventional monetary policy was also more fundamentally challenged by diminishing returns to monetary policy expansion as the benchmark interest rate came closer to the “lower bound”\textsuperscript{17}. As a result, the primary focus of the ECB switched from the adequate monetary policy stance considering economic activity to restoring financial stability and repairing the transmission mechanism.

The late 2008 coordinated stimulus avoided an outright depression in 2009/2010, but it also contributed to weaken the most fiscally fragile Member States and illustrated the difficulty of managing the economic cycle of the union through a collection of national budgets. In this sense, it proved that if coordination can work, the institutional capacity to take fiscal policy decisions for the union as a whole remains weak and needs to be reinforced. But the crisis also illustrated that there were no instruments to respond to shocks affecting individual Member States and national automatic stabilisers were too weak to respond to shocks of this magnitude. Whether these shocks were the result of the normal business cycle or the outcome of more idiosyncratic fiscal, external or banking shocks, European and national authorities had built a policy apparatus largely incapable of dealing with non standard economic shocks. In the face of subsequent loss of market access by a Member State, Europeans policymakers were stuck between the rock of their refusal to accept sovereign defaults and the hard place of their rigorous interpretation of Article 125—the so-called “no bailout” clause—of the Treaty. The former, was governed by concerns for financial stability and contagion,\textsuperscript{18} the latter was grounded in the spirit of the \textit{Delors consensus} and the overwhelming ordo-liberal concern for moral hazard. After months of costly hesitations, Europeans initiated a process that would lead to mechanisms of mutual financial assistance initiated by bilateral loans and then largely grounded on inter-governmental guarantees arranged inside an insurance mechanism, the so called European Financial Stability Facility (EFSF), which would later be adapted before the creation of a permanent European Stability Mechanism\textsuperscript{19} (ESM) after a modification of Article 136 of the Treaty. This was formally the end of the Maastricht architecture, as the need for financial solidarity within EMU was formally established, but not quite yet the beginning of a new one.

\textsuperscript{15} See Jonung and Drea (2009).
\textsuperscript{17} See Woodford discussion at Jackson Hole in August 2012. Woodford, Michael, Methods of Policy Accommodation at the Interest-Rate Lower Bound, Columbia University, August 20, 2012.
\textsuperscript{18} See notably the speeches by then ECB Executive Board member Lorenzo Bini-Smaghi who argued repeatedly that default and restructuring were politically, democratically and socially very costly and not suitable for advanced economies such as that of the euro area. http://www.ecb.int/press/key/date/2011/html/sp110606.en.html.
\textsuperscript{19} The European Stability Mechanism (ESM) was established on 27 September 2012 and will replace the temporary European Financial Stability Facility (EFSF). The EFSF will continue to manage existing commitments until they are fully repaid and can make additional loans until the middle of 2013.
4. Repairing the monetary union by sharing economic risks

The predominant—but inaccurate—narrative of the crisis as essentially a public debt crisis has helped to promote a number of deep changes to improve arrangements to ensure fiscal discipline in order to remedy the shortcomings of the Stability and Growth Pact. But even though fiscal discipline is an important pillar of a monetary union, it is not sufficient to ensure its stability. Historical and international experiences of monetary unions suggest in fact that a stable monetary union, unlike a simple currency arrangement is defined by a broader set of instruments to share economic risks and allow for more symmetric adjustment to economic shocks.

4.1. Risk sharing through the financial sector

The financial sector has, in principle, strong stabilisation capacity allowing it to absorb economic shocks\(^\text{20}\) both across regions and inter-temporally. This was an important contribution of the literature in the 1990s, notably by Asdrubali et al. (1996) who demonstrated the extent to which the US financial system could smooth economic fluctuations. Yet few economists understood then the degree to which mechanisms to internalise the consequences of financial integration should be an essential feature of the European Monetary Union. The banking crisis Europe is going through and the tragic consequences it has had on public finances are such that it is now widely accepted that the fragilities of the financial sector might come to reduce tremendously its theoretical shock absorption capacity, or worse that it could itself cripple sovereign balance sheets, taxpayers and eventually become a source of economic disruptions that can contribute to fragment the currency union. This requires the creation of a framework allowing common resolution. That is to say: an institution with enough executive power to close, wind down or restructure a bank safely anywhere in the monetary union and arrangements to commit fiscal resources as an ultimate backstop to recapitalise the banks when necessary and protect insured depositors.\(^\text{21}\) This should be the very nucleus of a common fiscal capacity for the euro area, which would in effect only be used to respond to contingent financial risks that occur rarely but that require risk sharing when they do.

4.2. Fiscal policy coordination

Fiscal policy coordination has been generally weak and has not allowed member states to maximise the effectiveness of fiscal policy for the purpose of macro-economic stabilisation. The fiscal stance of the euro area is the simple sum of national fiscal stances largely decided independently of each other. Fiscal multipliers and spill-over effects are ignored and there are limited coordination efforts deployed to achieve an appropriate fiscal stance for the euro area as a whole. This is a shortcoming that the European Commission itself acknowledges by demanding, in its 2013 recommendations\(^\text{22}\) to the Eurogroup that it: “monitors and coordinates fiscal policies of the euro area Member States and the implied aggregate fiscal stance for the euro area as a whole to ensure a growth friendly and differentiated fiscal policy”. At the moment, the ability for fiscal policy to effectively deliver macroeconomic stabilisation, beyond the national automatic stabilisation is limited. To achieve real coordination, Member States would need to engage in deeper ex ante joint budgetary planning as well as regularly report to a common authority on compliance with the objective of achieving the adequate fiscal policy rather than solely focus on achieving a balanced budget rule through the cycle. This would mean upgrading economic policy discretion at the European level more than the simple application of fiscal rules, however sophisticated they might be. More importantly, in order to coordinate effectively, there needs to be a stronger but also more accountable executive authority that can decide on fiscal policy for the euro area and apportion the national targets accordingly. This would certainly

\(^{20}\) Asdrubali et al. (1996).


\(^{22}\) Country specific recommendations addressed to the euro area as a whole: http://ec.europa.eu/europe2020/pdf/nd/CSR2013_euroarea_en.pdf.
4.3. Asymmetric shock absorption

In the context of a monetary union, national automatic stabilisers might be too small to respond to deep or protracted output loss. There might, in addition, be a natural tendency to free-ride on the automatic stabilisation of one’s neighbours. The ESM does serve this purpose but only *ultima ratio* and it is quite possible that other limited, but more pre-emptive instruments could actually facilitate adjustments and reduce the probability of having recourse to the ESM. Therefore, new instruments to assume such asymmetric shock absorptive features should be pursued. These can be achieved by different mechanisms of pooling of resources and transfers to countries experiencing shocks based on deviation from potential growth, deviation in the borrowing cost (spreads), deviation in employment. These could be financed by the pooling of a small portion of fiscal revenues (e.g. a portion of income, sales or corporate tax for instance) and should still be complemented by existing national automatic stabilisation mechanisms.

4.4. Creation of safe and liquid asset

The euro is probably the only currency that has managed such a successful internationalisation without a unified, deep and liquid government bond market. This has at least two important consequences. The first is that it has maintained a degree of home bias where banks felt or were compelled to build large exposures to their national sovereign debt.24 This lack of diversification in turn increases the risks of financial instability and the vicious feedback loops between the banks and their respective sovereign. The second is that the absence of a real, deep and liquid government bond market curtails the rise of the euro as a leading reserve currency and limits the area’s ability to enjoy the benefit of an overall lower liquidity premium. A common government reference asset would greatly contribute to financial stability domestically, limit risks of destabilising dispersion of borrowing costs between member states and finally play an important role for the global attractiveness of the euro and eventually increase the stability of the international monetary system.25 Issuance of common debt has already started in the form of the debt issued by the mutual insurance mechanisms (EFSF, EFSEM and ESM) and the strengthened fiscal framework (6-pack, Treaty on Stability, Cooperation and Governance and more recently two-pack) could provide more comfort to expand the issuance of such instruments but the multiplication of these instruments issued by different institutions fragments the market for common debt, reduces its depth and therefore limits their. Beyond these issues, a common debt would inevitably play a form of redistributive role by arranging implicit transfers. With a common debt, countries with low credit premium are effectively lending their credibility to countries that would otherwise borrow at much higher interest rates. This can allow correcting excessive credit premia but it also weakens the price signals and may in turn set inadequate fiscal incentives. To retain the power of market based signals and incentives, it is therefore important that national debt remains along this common debt.26

5. Towards a new architecture: from inter-governmental insurance to fiscal federalism

Understanding the limits of the current architecture and the essential features of a stable new monetary union does not offer a clear path towards it. In a pure and perfect model, a complete and

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23 See Nicolas Véron testimony to the US Senate Committee on Foreign Relations Subcommittee on European Affairs hearing on “The Future of the Eurozone: Outlook and Lessons”.
24 For an early account of risks related to accumulation of national public debt in banks balance sheets, see Eichengreen and Wyplosz (1998).
26 For more on the various common debt options and their respective pros and cons, see Claessens et al. (2012).
friction-free banking union could probably absorb and mutualise enough of the economic fluctuations to allow the monetary union to function smoothly\textsuperscript{27} even without an additional fiscal capacity. But this would also require the convergence of a wide range of other policies including bankruptcy and restructuring policies for private and public sector debtors across the monetary union. This is the model advocated by those who consider that if financial markets could function properly again\textsuperscript{28} via the establishment of a banking union, capital markets would be able to absorb and spread economic shocks sufficiently to sustain the monetary union.\textsuperscript{29} Such a theoretical banking union would, even if effective from a shock absorption point of view, have a deeply negative bearing on financial stability. As the US example illustrates, capital markets are able to absorb a large part of economic shocks precisely because the rest is absorbed by the federal budget. In the absence of fiscal risk sharing mechanism, transfers would be limited to those offered by capital markets through potentially disruptive private sector and sovereign defaults and therefore some inevitable cost to potential output and economic stability. In addition, so long as the stock of public sector debt remains so large, sovereign defaults would, despite the banking union, be too disruptive to become an effective adjustment variable.

5.1. Mutual insurance

Because the treaties ignored the need for mechanisms to absorb shocks and provide assistance to member states in difficulties, these had to be developed under duress and emergency. In addition, following the June Euro Area Summit statement, the ESM will be allowed to recapitalise banks directly.\textsuperscript{30} Finally the ESM has become the cornerstone of the ECB’s Outright Market Transactions (OMT), which is also designed to provide a form of insurance against extreme financial fragmentation\textsuperscript{31} through interventions in sovereign debt markets. The increasing number, size and scope of these instruments recognises the economic interdependence and the need for mutual insurance between Member States that the Delors consensus failed to grasp fully. But these mechanisms as they are structured represent a contingent risk on national budgets and therefore justify mutual controls. As the mutual insurance framework widens and deepens, it is natural to expect, that in order to contain contingent risks weighing on them, Member States would seek to set up appropriate monitoring and corrective devices on each other. This is very much reflected in the logic of the recent governance changes in the euro area such as the 6-pack, the TSGC and the two pack that are all contributing to gradually move the disciplining devices beyond ex post monitoring and sanctions to a much a more pre-emptive and binding set of mechanisms constraining national budgets. However, these control mechanisms are either outsourced to the European Commission (6-pack and in the future, two-pack) or based on automatic rules (TSGC) that limit the actual intrusion by Member States on each other’s economic policies reflecting a democratic discomfort with actual economic policy ingérence. So if solidarity mechanisms do function through a clear and explicit intergovernmental logic, where national parliaments can object and block assistance programs, the control dimension is far less accepted because the notion of a national authority or parliament censoring or challenging another one is fundamentally problematic from accountability and democratic legitimacy point of view. All in all, these developments highlight a shift towards a real intergovernmental mutual insurance dynamic\textsuperscript{32} but this logic appears economically insufficient and politically unsustainable as the reticence about outright and direct intrusion illustrates.

\textsuperscript{27}See Gros (2012).
\textsuperscript{28}For more on an architecture based on a solid banking union and sovereign defaults, see Mayer, Thomas, Europe’s unfinished currency: The political Economics of the Euro, http://europesunfinishedcurrency.anthempressblog.com/?page_id=6.
\textsuperscript{29}This view has been defended in particular by Gros (2012).
\textsuperscript{31}https://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html.
\textsuperscript{32}Jean Pisani-Ferry has highlighted the limitation of such a model where national parliaments cannot integrate the broader European common interest which shows the practical and democratic limitation of this approach.http://www.bruegel.org/publications/publication-detail/publication/719-the-messy-rebuilding-of-europe/.
Mutual insurance arrangements were initially limited in scope and size. They have been substantially expanded over the last couple of years but the current instruments still take effect very late and at a stage when Member States’ economic situation is so dire that assistance becomes absolutely necessary. A more pre-emptive system that would organise some sharing of risks ex ante rather than ex post would have stronger stabilising properties and would also reduce the final costs of support. To the extent that these economic shocks are reflected in sovereign debt spreads, a form of limited common debt issuance could allow all member states to insure themselves more effectively against adverse shocks by ensuring that they can all borrow at least partially at the same lower rate. A number of “Eurobonds” proposals with varying structures and properties have been laid out producing more or less similar effects on borrowing costs for member states. They vary in a number of technical aspects, such as the type and amount of shared guarantees, or whether they chose to focus on the flow of new debt or on the stocks. But they all rely on a similar logic of mutualisation of national debts.

The path followed to creating such common debt has however important political consequences. In reality, the current mechanisms of mutual insurance already produce a form of common debt, the debt now issued by the EFSF with the underlying guarantees of member states. This commitment is already in excess of 240 billion for the EFSF and potential future programmes will be financed by the ESM. But risk pooling is in fact much larger than the official resources committed if one considers the debt implicitly mutualised by the ECB via its Securities Markets Programme (more than 200 billion euros) and in the future through its Outright Monetary Transactions (a potentially unlimited amount). The euro area has therefore already started to mutualise debt without the explicit creation of “Eurobonds”.

In this context, it is useful to connect economic principles to their political and institutional translations and consider them as a system. The prospect of expanding the pooling of national debt with the current insurance and control framework poses important questions. Beyond the usual debates revolving around incentives, moral hazard and legality (compliance with article 125 and 136 of the Treaty), this would raise very fundamental political questions about budgetary sovereignty. Indeed, in order to develop real Eurobonds, it is very likely that member states would seek to contain the risks weighing on their national budgets by expanding controls possibly as far as seeking the right to veto national budgets ex ante. Yet it is hard to imagine that Member States would sustain vetoes by a fellow Member States or by the European Commission acting effectively on the basis of an intergovernmental mandate rather than a genuine community one controlled and legitimised by the European Parliament. This approach would lead Member States that are reluctant to accept more intrusions in their national budgets to agree with those that are not willing to accept the risks associated with greater mutual insurance. This impasse highlights the importance but also the inherent limitations of the current mutual insurance system.

5.2. Fiscal federalism

This political difficulty created by the intrusion in national budgetary sovereignty cannot be completely evaded by fiscal rules or by outsourcing these prerogatives to the European Commission. A more formal pursuit of debt mutualisation in exchange for more direct controls such as veto rights on national budgets overlooks both the fact that the Treaty precisely limits the European Commission’s prerogatives when it comes to binding national economic policies and the need for real macroeconomic policy instruments at the European level. This economic governance dark matter means that the rebuilding of the currency union in that way will require either a change of the EU Treaty or through a supplemental Treaty like the Treaty on Stability Coordination and Governance.

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33 See Blisjma and Vallee (2011).
34 For a more detailed analysis of a number of these options see, Claessens et al. (2012) http://www.bruegel.org/publications/publication-detail/publication/733-paths-to-eurobonds/.
35 The report “Towards a genuine economic and monetary union” presented in June by the President of the European Council in close coordination with the Presidents of the European Commission, European Central Bank and Eurogroup suggested pursuing gradual steps of mutualisation commensurate with additional controls.
This legal obstacle along more fundamental political resistance to visible fiscal transfers between Member States largely explains why risk sharing has remained largely ad hoc or concealed rather than systematic and transparent. More fundamentally, this questions the ability both economically and politically to perform all the necessary functions necessary for the success of the monetary union with the existing institutional and legal set-up and the current mutual insurance logic.

The international history of fiscal federalism\(^{36}\) can prove a useful guide in this respect. Various experiences illustrate how the pooling of national debt without an appropriate governance structure can have profoundly damaging consequences. In their lesson of US history for the architects’ of Europe’s fiscal union, Henning and Kessler (2012) recalled quite clearly that even though the assumption of the war of independence’s debt in 1790 by the Federal Government orchestrated by Hamilton set in motion America’s fiscal federalism and largely redefined the institutional and power balance set out in the 1787 Constitution, it also fell short of providing the real backbone of a complete and stable fiscal union as the States’ defaults in the 1840s and ultimately the Civil War in 1870 would later come to demonstrate. Hamilton obtained only a part of the fiscal union he had sought and fell short of the definition of economic prerogatives for the nascent federal government and a clear definition of its relationship with States.

There are important parallels to the current debate on EMU’s architecture and the future shape of fiscal federalism in Europe. If the mutualisation of debt has powerful economic effects, alone, it is a poor substitute for a comprehensive definition of the system that organises the relationships between the Member States and the federal level. The creation of an embryonic euro area budget with appropriate functions could therefore address the shortcomings of the current architecture and the weaknesses of the mutual insurance system. In the beginning, it would not need to replace it altogether and could potentially evolve as its natural extension by delivering the mutualisation of economic risks needed through a central, democratic and accountable authority that the current system cannot produce. This should not only provide for what Musgrave (1959) referred to as the stabilisation function usually best delivered at the central level, but also help define the relationship between the central and national authorities in a clear and transparent manner. The pursuits of the existing or additional controlling devices can only be envisaged in the context of a federalisation of the existing mutual insurance tools. This would allow to building out subsequently additional instruments allowing for a degree of centralisation of the stabilisation function of national fiscal policy. However, beyond the definition of essential prerogatives and an agreement on its resources, the creation of this euro area capacity raises a number of political and transitional challenges.

5.3. Transitional considerations

Other experiences of fiscal federalism highlight two salient points.\(^{37}\) The first is that some mutualisation of economic risks alone is necessary but clearly not sufficient. The Hamiltonian experience of mutualisation of State debt in the absence of adequate political and economic institutions cemented structural divergences and inadequate incentives. Nonetheless, Hamilton took the very basic foundational step on which an evolutionary process could take root. The federal budget indeed evolved from a small shell in 1790 to a large one today through successive small steps and larger ones as a result of the Rooseveltian response to the Great Depression for example. Interestingly, the balanced budget rule that binds most US States was never imposed by the Federal Government but rather self-imposed following the heavy economic toll paid by individual States after the defaults in the 1870s.

For Europe’s Economic and Monetary Union today, one could consider the recent mutual insurance tools and the associated mutualisation as forming the basis of a proto-budget. Formalising it would require integrating the sum of ad hoc mutualisation instruments into a new compact that would lay the foundation of Europe’s fiscal federalism. In particular, it would involve defining the contours of a few key prerogatives to be conducted at the central level for the proper functioning of the euro area.

\(^{36}\) See: Bordo et al. (2011).

\(^{37}\) See IMF Staff Note: Towards a fiscal union for the euro area (2013).
Lessons from fiscal federations

Historical experiences show that in fiscal federations, the size of the central budget tends to be inversely proportional to the constraints imposed on sub-federal fiscal authorities. It is particularly interesting to note that there are no successful experiences of explicit direct controls by the central level to the sub-federal level, these controls and disciplining devices are in fact exercised by financial markets through no bail out rules that are more or less enforced depending on the federation.

A number of federations with weak no-bail-out rules have been able to flourish, while in some federations such as Australia that have tried to impose strict limits on the deficits and borrowing of sub-federal levels of governments (in 1927 via the creation of the Loan Council), this has eventually failed and as a result gradually evolved towards a more canonical centralisation of key fiscal prerogatives at the central level (transfers through Special Loans agreed in 1951). As a result, the share of taxation raised by the Commonwealth evolved from 0% in 1898 to 82% in 2001.

In Germany, the fiscal federalism instituted since 1870 has instituted a very loose no-bail-out rule of the Landers which has been violated repeatedly when bail outs of Landers were upheld in the Courts. This is slowly evolving with recent reforms that establish debt brake rules but it is still unclear the extent to which this will indeed bind the Landers.

<table>
<thead>
<tr>
<th>Countries</th>
<th>No bail out rule</th>
<th>Expenditure Decentralisation (1)</th>
<th>Fiscal autonomy (2)</th>
<th>Borrowing autonomy (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>No</td>
<td>46,2</td>
<td>18</td>
<td>4</td>
</tr>
<tr>
<td>USA</td>
<td>Yes, enforced</td>
<td>45,2</td>
<td>34,4</td>
<td>3</td>
</tr>
<tr>
<td>Germany</td>
<td>Yes, but weak</td>
<td>43,7</td>
<td>29,2</td>
<td>2,5</td>
</tr>
<tr>
<td>Brazil</td>
<td>No</td>
<td>42,8</td>
<td>28</td>
<td>4,5</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Yes, enforced</td>
<td>63,5</td>
<td>40,8</td>
<td>3</td>
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<td>Canada</td>
<td>Yes</td>
<td>72,7</td>
<td>44</td>
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</tr>
<tr>
<td>Australia</td>
<td>No</td>
<td>45,3</td>
<td>30,8</td>
<td>2,5</td>
</tr>
<tr>
<td>India</td>
<td>No</td>
<td>49</td>
<td>33</td>
<td>2,5</td>
</tr>
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In this respect, the Treaty on Stability Coordination and Governance, or the provisions of the Two-pack for instance appear already more ambitious than what the German Federal Government has managed to impose on the German Landers for example.

The Swiss model is also particularly instructive, the increasing level of public spending by the Federal Government (from 2% of GDP in 1870 to 12% in 2012) remains based on a system of temporary devolution of prerogatives and taxing power by the Cantons to the Federal Government that need to be renewed every 10 years. Economic necessities have imposed centralisation of some economic functions but the underlying political compact and the governance of this arrangement continues to rest on the Cantons.

(1) Expenditure decentralisation: sub-national expenditures/total expenditures. IMF, Global Financial Statistics
(2) State Local tax revenues/ Total revenues, OCDE
(3) Index of borrowing autonomy constructed by the Inter-American Development Bank. It considers debt authorisation requirements and limits on the use of debt imposed by the central government. This variable ranges from 1 to 5.
This embryonic euro area budget should, as a result of its prerogative, be able to issue debt in common, which more than pooled national sovereign debts would be a proper federal debt instrument. The establishment of such a federal fiscal capacity would limit the need for direct interference and control of national budgets that is justified under the mutual insurance logic. It would allow necessary transfers and thereby reduce the probability of sovereign defaults. However, even if the objective could be to apply a strict no-bail-out rule in the future, during the transition phase, the stock of national debts is probably going to remain so large and the euro area central budget so small that the no bailout rule would lack credibility. It is therefore reasonable to expect that EMU fiscal federalism would, during this period, probably resemble the current German fiscal federalism where Member States, as Landers now, would retain a large degree of independence over their fiscal matters under a formal no-bail–out rule that would be only weakly enforced. Indeed, in practice the same way the no-bail out-rule in Germany is largely circumvented by the Solidarpakt, it would be in EMU by the recourse to the ESM financial assistance (interestingly, even in the context of bail-outs by the Federal Government, Landers are protected by the Constitutional Court from the type of policy conditionality and intrusion that programme countries have experienced in the EMU).

But after this transition phase and provided national budgets have shrunk as the euro area budget increases and the macroeconomic stabilisation competence is centralised; there are various possible models of fiscal federalism that will require decisive political choices fairly early in the transition process. A Swiss model with a relatively small federal budget (about 10% of GDP) under control and time bound taxing authorisation of the Cantons for instance, or a more American model with a larger Federal Budget (about 25% of GDP) and a strict and enforced no-bail-out rule on States. These different models would correspond to the evolution of the political architecture of the Union more broadly. A confederation along the Swiss model would certainly involve a more limited federal budget with greater powers and responsibilities at the national level than a real federation. But in any case, the creation of a euro area fiscal capacity and the transfer of national economic policy prerogatives to the European level would be more consistent with Europe’s political tradition than an ever more stringent and ever less democratic intrusion and interference with national economic policy through veto rights on national budgets. Indeed, a more federal system would provide for a system where democratic legitimacy and accountability is more clearly aligned with decision making at the national and European level, respecting an appropriate degree of autonomy for Member States while recognising the fundamental interdependence and the need for collective action tools that the previous architecture purposefully ignored.

6. Conclusion

There is growing awareness that the European crisis was largely caused by inherent deficiencies of the Maastricht architecture. A nascent intellectual consensus is emerging arguing for the need to overhaul the financial architecture of EMU through the federalisation of supervision, resolution and the creation of a common guarantee of deposits. This is an important step but still falls short of the complete rebuilding of the economic policy architecture and more specifically the definition of the shape and form of fiscal federalism required for the monetary union to function properly.

The current logic of inter-governmental insurance mechanism (EFSF, ESM, OMT…) has proven potent for the purpose of crisis management but it is economically limited and politically unsustainable without the “state of emergency” that is imposed by the crisis. Yet it forms a useful and important precedent that can gradually evolve towards the creation of a proper risk sharing arrangement through a euro area budget thereby setting in motion a process of fiscal federalisation aiming at centralisation of some key prerogatives and economic policy powers. This should be able to address the proven limitations of the current system of peer review that is largely unable to enforce fiscal discipline; it would allow moving gradually towards the enforcement of a credible no bail out clause of Member States. Meanwhile, the creation of an executive economic decision making power would overcome the weakness of the current coordination framework and supersede the modest interference in national economic policies with a view of allowing effective, legitimate and time consistent economic policy decisions in the best interest of the union as a whole.
But historical experiences of fiscal federalism highlight the great diversity in the way the degree of centralisation, the relationship between the federal and regional levels of fiscal authorities are organised and the extent to which these follow the general optimality prescriptions of Oates (1972). This debate has become essential for the economic stability of the euro area but more fundamentally to secure its political sustainability. Multi-national currency unions (USSR, Former Yugoslavia…), as opposed to national ones38 (Australia, Germany, Canada…), are fragile constructs that are fundamentally dependent on the political compact on which they are based. In the case of EMU, the underlying compact is profoundly challenged because the intellectual consensus on which it rests is no longer current. Proposing a new compact, redefining executive economic prerogatives and settling the associated governance and democratic legitimacy structures has become an urgent priority to rebuild the monetary union and salvage the European integration process.

References


Pisani-Ferry Jean. The known unknowns and the unknown unknowns of the EMU. Bruegel Policy Contribution; October, 2012.


38 This distinction between national and non national currency union is somewhat fragile because the process of establishing a national identity is a long lasting one but it is potentially useful approximation to qualify political ensemble with varying degrees of political integration. See Bordo and James (2008).
Further Reading


Commission of the European Communities Directorate-General For Economic And Financial Affairs. One market, one money: an evaluation of the potential benefits and costs of forming an economic monetary union. European Economy. No. 44; 1990.


